

PAO/NSIA



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

June 25, 1997

THE DIRECTOR

The Honorable William S. Cohen
Secretary of Defense
1000 Defense Pentagon
Washington, D.C. 20301-1000

Dear Secretary Cohen:

Thank you for your letter of May 16, 1997, about the future of the Military Housing Privatization Initiative (MHPI). I share your concerns and I am encouraged by the Department's desire to pursue privatization of military housing. I also appreciate the Department's enormous effort to get this pilot program off the ground.

Enclosed are the guidelines that the Office of Management and Budget and the Department of Defense should use for scoring housing projects authorized by the MHPI in Public Law 104-106. These guidelines replace the previous guidelines and will remain in effect for the first 20 projects that use MHPI authorities. OMB will adjust the guidelines, if necessary, to incorporate the lessons learned during implementation of these projects.

I urge you to facilitate competition to the maximum extent feasible as the Department implements the MHPI. Letting the marketplace guide your actions will enhance the Department's ability to achieve the MHPI's main goal -- improving the quality of life for our military service members at the lowest cost to the Department. I also want to emphasize that the cost of assistance offered by the Department to providers of private housing must be clear, fully accounted for, and thoroughly considered when making decisions on individual privatization projects. OMB will help the Department achieve these objectives throughout the course of this pilot program.

I look forward to working with the Department to implement this vital program.

Sincerely,

Franklin D. Raines
Director

Enclosure

SCORING OF DOD's MILITARY HOUSING PRIVATIZATION INITIATIVES

Military Housing Privatization Initiative Authorities

The Military Housing Privatization Initiative (MHPI) in P.L. 104-106 provides DoD with many authorities that may be used to attract private capital investment for revitalizing the stock of military housing. This document defines the guidelines that OMB will use to determine the budgetary impact of DoD's use of these authorities.

Scoring Determines Obligations to be Recorded

Each privatization agreement that DoD enters must be scored for budget purposes. Scoring seeks to determine the cost that should be recognized and recorded as an obligation of DoD at the time a contract is signed. Sufficient appropriations must be available to cover the amount obligated for each contract. The Department, with OMB concurrence, will determine the amount of funds to be obligated to cover future costs that are associated with the use of the tools provided in the MHPI.

Direct Loans and Loan Guarantees

Two important financing tools available to DoD for housing revitalization efforts are direct loans and loan guarantees. Each provides a government subsidy that must be considered and accounted for in making financing decisions. For direct loans, the government provides funds directly to a private borrower and agrees to absorb a portion of the cost of a default by the borrower. For loan guarantees, the government makes a binding commitment to absorb a portion of the cost of default on credit extended by a private financial institution to a private borrower. The budget impact of using each of these authorities must be estimated and sufficient funds obligated to cover the estimated cost to the government.

The amount of obligations to be recorded for a direct loan or loan guarantee depends on the subsidy rate. The rate represents, in net present value terms, the cost of estimated defaults (net of recoveries) and interest rate subsidy, if any, over the life of the loan or loan guarantee. For example, if the subsidy rate is 25 percent, obligations of \$10 million would be recorded for a \$40 million of loan or guarantee. Before funds are obligated for a loan or guarantee, appropriations sufficient to cover the subsidy cost of each project must be available in the Family Housing Improvement Fund.

Participation Test for Direct Loans and Loan Guarantees

For both on-base and off-base revitalization project, substantial private sector risk is necessary to conform with the provision of the Federal Credit Reform Act. Each housing privatization project that uses a direct loan or loan guarantee must meet the following risk, or "participation" test: at least 20 percent of all resources for a project must be provided by private sources. If a project does not pass the participation test, the full

amount of a loan or guarantee will be recorded as an obligation. This is especially critical for on-base projects, given the inherently governmental nature of any construction and federal use of projects built on federal land. Additional information for determining government and private sector participation is included at the end of these guidelines.

Additional Considerations for Direct Loans and Loan Guarantees

Loans that subordinate the government's position, but have fixed repayment schedules, are scored like first mortgages. The credit subsidy, however, may be higher because the government is not the first creditor to be paid in case of default. Soft second mortgages, loans without a fixed repayment schedule, will be scored as grants, or equal to 100% of the loan. A guarantee of bonds that are exempt from Federal taxes will be recorded as an obligation equal to 100 percent of the amount of the guarantee.

Discount Rate for Direct Loan and Loan Guarantee Calculations

DoD should use the interest rate on Treasury securities of similar maturity to the loan. This is the rate required by the Federal Credit Reform Act to estimate the cost of credit programs for the budget. The government should make its decisions based on its own cost of borrowing, and it should use the same rate for all forms of government subsidies so as to provide consistent measures of cost.

Differential payment, Income or Occupancy Guarantees and Leases

Differential payment, income or occupancy guarantees and leases provide, or seek to guarantee an income stream to a housing provider. Use of these authorities will be scored "upfront", with the entire net present value of the lease or commitment recorded as an obligation at the time a contract is finalized.

Investments

If the Department acquires part ownership of a corporation or limited partnership through the purchase of stocks, bonds, or other types of equity an obligation will be recorded equal to the cash investment at the time a contract is finalized.

Conveyance of Real Property

The Department may convey property in exchange for housing or an equity investment in a corporation or limited partnership. There will be no scoring impact if there is no cash income or expenditure.

Provision of Goods and Services

the Department shall not provide goods or services that would normally be paid for by a developer, home owner, or tenant (e.g. utilities, maintenance, waste removal, pest control,

snow removal, or roads for exclusive use in housing areas) as a subsidy to housing providers. When appropriate, the Department may provide goods and services, at cost, to housing providers or tenants. If used, the subsidy value will be scored.

Assignment of Service Members to Housing

The assignment of service members to private housing is inconsistent with privatization. Moreover, assignment of services members would reduce economic risk to the private sector and reduce incentives for private developers to build, operate and maintain quality housing. Any proposal to privatize DOD family housing should not include assignment of service members to that housing. Assignment of service members to housing, when combined with a loan guarantee for base closure, deployment and downsizing, would effectively eliminate default risk, and therefore, would require the full face value of the loan to be counted as government participation.

OMB Review Process

OMB will work with the Housing Revitalization support Office (HRSO), prior to issuance of a Request For Proposal (RFP) and prior to final contract award, to review and approve/amend the HRSO's scoring determinations for each proposed project. If the parameters of a project remain consistent from the RFP development stage through final contract award, OMB does not anticipate making significant changes after scoring determinations are made during the RFP development stage. Items to be reviewed include, but are not limited to:

- percentage of government and private sector participation;
- qualification for credit reform scoring;
- credit reform subsidy estimates; and
- total obligations to be recorded at the time of contract signing.

OMB will review HRSO scoring determinations as quickly as possible, especially during the period immediately preceding final contract award.

Interpretation of Government and Private Sector Participation

The factors that HRSO and OMB will consider Federal government participation include:

- Value of units conveyed to private developer
- 100 percent of the loan amount guaranteed by the Federal government, unless the Department issues a loan guarantee that protect a lender only in case of default due to base closure, deployment, or downsizing. Then 10 percent of the value of a first mortgage shall be considered as government participation. The participation percentage may vary, up or down, depending on the specific conditions that would trigger payment under such a guarantee.
- 100 percent of the amount of a direct loan by the Federal government
- Cash investment
- Differential payments
- Income or occupancy guarantees.

The factors that HRSO and OMB will consider private sector participation include:

- Cash Investments
- Value of assets other than cash (excluding assets conveyed to private sector by the Federal government)
- Portion of net income generated by new units used to fund construction and revitalization costs or capital improvements, or in the case of revitalized units, the portion of net income (after revitalization) used to fund construction and revitalization costs or capital improvements.
- 90 percent of the value of a first mortgage if the Department issues a loan guarantee that protects a lender only in case of default due to base closure, deployment, or downsizing. The participation percentage may vary, up or down, depending on the specific conditions that would trigger payment under such a guarantee.

Utilities

If DoD contract to pay for utilities for more than one year, the net present value of the expected payments will be recorded as an obligation and considered to be government participation. Contracts for utility payments that are subject to future appropriations will not be considered to be government participation.